Management Report

for

City of Arden Hills
Ramsey County, Minnesota

December 31, 2012

MMKR
CERTIFIED PUBLIC
ACCOUNTANTS

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To the City Council and Management
City of Arden Hills, Minnesota

We have prepared this management report in conjunction with our audit of the City of Arden Hills, Minnesota's (the City) financial statements for the year ended December 31, 2012. The purpose of this report is to provide comments resulting from our audit process and to communicate information relevant to city finances in Minnesota. We have organized this report into the following sections:

- Audit Summary
- Funding Cities in Minnesota
- Governmental Funds Overview
- Enterprise Funds Overview
- Government-Wide Financial Statements
- Accounting and Auditing Updates

We would be pleased to further discuss any of the information contained in this report or any other concerns that you would like us to address. We would also like to express our thanks for the courtesy and assistance extended to us during the course of our audit.

The purpose of this report is solely to provide those charged with governance of the City, management, and those who have responsibility for oversight of the financial reporting process comments resulting from our audit process and information relevant to city finances in Minnesota. Accordingly, this report is not suitable for any other purpose.

Malloy, Montague, Karnowski, Radosevich, & Co., P.A.

Minneapolis, Minnesota
June 18, 2013

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AUDIT SUMMARY

The following is a summary of our audit work, key conclusions, and other information that we consider important or that is required to be communicated to the City Council, administration, or those charged with governance of the City.

OUR RESPONSIBILITY UNDER AUDITING STANDARDS GENERALLY ACCEPTED IN THE UNITED STATES OF AMERICA AND *GOVERNMENT AUDITING STANDARDS*

We have audited the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City as of and for the year ended December 31, 2012. Professional standards require that we provide you with information about our responsibilities under auditing standards generally accepted in the United States of America and *Government Auditing Standards*, as well as certain information related to the planned scope and timing of our audit. We have communicated such information to you verbally and in our audit engagement letter. Professional standards also require that we communicate the following information related to our audit.

PLANNED SCOPE AND TIMING OF THE AUDIT

We performed the audit according to the planned scope and timing previously discussed and coordinated in order to obtain sufficient audit evidence and complete an effective audit.

AUDIT OPINION AND FINDINGS

Based on our audit of the City's financial statements for the year ended December 31, 2012:

- We have issued an unqualified opinion on the City's basic financial statements.

- We reported one matter involving the City's internal control over financial reporting that we consider to be a material weakness as detailed in the Special Purpose Audit Reports. Due to the limited size of the City's office staff, the City has limited segregation of duties in certain areas.

- The results of our testing disclosed no instances of noncompliance required to be reported under *Government Auditing Standards*.

- We reported no findings based on our testing of the City's compliance with Minnesota laws and regulations.

FUND BALANCE DEFICITS

As reported in the City's comprehensive annual financial report (CAFR), the Equipment, Building, and Replacement Fund; Economic Development Authority (EDA) TIF District No. 4 Fund; Parks Fund; and Central Garage Internal Service Fund had year-end deficit equity balances of $232,240, $973, $70,126, and $17,224, respectively. Management has disclosed that these deficits will be eliminated with future contributions, grants, and internal fund transfers if needed.

SIGNIFICANT ACCOUNTING POLICIES

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the City are described in Note 1 of the notes to basic financial statements. For the fiscal year ended December 31, 2012, the City implemented Governmental Accounting Standards Board (GASB) Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. GASB Statement No. 63 changed how governmental entities present a statement of net position, adding two new basic financial statement elements, and replacing "net assets" with "net position" as the terminology used to describe the difference between the other four elements. The two basic financial statement elements added are "deferred inflows of resources" and "deferred outflows of resources." These new elements are differentiated from assets (deferred outflows of resources) and liabilities (deferred inflows of resources), but have similar effects on net position.

We noted no transactions entered into by the City during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

ACCOUNTING ESTIMATES AND MANAGEMENT JUDGMENTS

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were:

- **Depreciation** – Management's estimates of depreciation expense are based on the estimated useful lives of the assets.

- **Compensated Absences** – Management's estimate is based on current rates of pay and unused compensated absence balances.

Management expects any differences between estimates and actual amounts of these estimates to be insignificant. We evaluated the key factors and assumptions used by management in the areas discussed above in determining that they are reasonable in relation to the financial statements taken as a whole. The financial statement disclosures are neutral, consistent, and clear.

CORRECTED AND UNCORRECTED MISSTATEMENTS

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. Where applicable, management has corrected all such misstatements. In addition, none of the misstatements detected as a result of audit procedures and corrected by management, when applicable, were material, either individually or in the aggregate, to each opinion unit's financial statements taken as a whole.

DIFFICULTIES ENCOUNTERED IN PERFORMING THE AUDIT

We encountered no significant difficulties in dealing with management in performing and completing our audit.

DISAGREEMENTS WITH MANAGEMENT

For purposes of this report, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

MANAGEMENT REPRESENTATIONS

We have requested certain representations from management that are included in the management representation letter dated June 18, 2013.

MANAGEMENT CONSULTATIONS WITH OTHER INDEPENDENT ACCOUNTANTS

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the City's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

OTHER AUDIT FINDINGS OR ISSUES

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the City's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the City's basic financial statements. Other information, including the introductory section, supplemental information, and statistical section accompanying the basic financial statements are presented for purposes of additional analysis and are not required parts of the basic financial statements.

With respect to supplemental information accompanying the financial statements, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplemental information to the underlying accounting records used to prepare the basic financial statements or to the basic financial statements themselves.

With respect to the introductory section and the statistical section accompanying the basic financial statements, our procedures were limited to reading this other information, and in doing so we did not identify any material inconsistencies with the audited financial statements.

FUNDING CITIES IN MINNESOTA

LEGISLATION

The 2011 Legislative Session was very long and difficult. It featured a large budget deficit and a very contentious battle between the Democratic Governor and the Republican-led House and Senate; and resulted in numerous vetoes, a special session, and the longest shutdown of non-essential state government services in Minnesota history.

The outlook going into the 2012 Legislative Session was brightened somewhat by positive economic news. The November 2011 financial forecast projected a surplus of $876 million in the state general fund for the biennium ending June 30, 2013, later revised to a surplus of almost $1.2 billion in the February 2012 forecast. This meant that the Legislature would not have to pass a "supplemental budget" to deal with projected shortfalls for the second half of the biennium, as was the case in the previous short session.

The positive feeling was short-lived, however, as the 2012 Legislative Session quickly degenerated into more partisan squabbling. Once again, the Governor exercised his veto power a number of times to block Republican legislative initiatives. The Republican Legislature reacted by introducing several potential amendments to the state constitution, which once passed would be subject to a public vote and could not be vetoed by the Governor. Two potential amendments, addressing voter identification and the legal definition of marriage, made it on the ballot for the November 2012 election and were voted down by the public. In the end, the main accomplishment of the session was a hard-fought compromise on partial public funding for a Vikings stadium.

The 2012 Legislature did pass a state bonding bill, a technical tax bill (after two omnibus tax bills were vetoed), and a few other bills that impacted Minnesota cities. The following is a summary of recent legislative activity affecting the finances of Minnesota cities in 2012 and into the future:

Local Government Aid (LGA) – The state-wide LGA appropriation for fiscal 2012 was $425.2 million. For fiscal 2012, cities received the lesser of their 2010 actual or 2011 certified LGA allocations. For fiscal 2013 and beyond, the state-wide LGA appropriation had been set to increase to $426.4 million; however, the 2012 Legislature made some changes. LGA payments for 2013 are frozen at 2012 levels for cities with a population of 5,000 or more. For cities with populations below 5,000, 2013 LGA will be the greater of their 2012 aid or the amount they would have received for 2013 under existing law. The Legislature also froze the base for calculating the maximum increases and decreases for a city's 2013 and 2014 LGA to their 2012 aid. Beginning in 2015, the previous year's LGA payment will be used to calculate the minimum and maximum increases.

Market Value Homestead Credit (MVHC) – The 2011 Legislature eliminated the MVHC reimbursement program beginning in fiscal 2012. Rather than receiving a property tax credit, qualifying homeowner taxpayers had a portion of the market value of their house excluded from their taxable market value. This new system provides homeowners property tax relief by shifting a portion of their potential tax burden to other property classifications, rather than directly reducing their taxes through a state paid tax credit reimbursement. While this new homestead exclusion is calculated in a similar manner to the repealed MVHC, the actual tax relief to individual homeowner taxpayers varies depending on the makeup of the taxing jurisdictions that levy on their particular property.

Depositories Authorized to Redeposit City Funds – Banks designated as depositories of city funds are authorized to redeposit the funds in another bank, savings and loan, or credit union located within the United States, provide the redeposited funds are fully covered by federal depository insurance (FDIC or NCUA). This law change was enacted to make additional federal depository insurance available to cover municipal deposits in anticipation of the December 31, 2012 sunset of the temporary unlimited coverage for non-interest bearing municipal accounts provisions of the Dodd-Frank Act.

Municipal State Aid (MSA) Eligibility – Three changes were made that protect the MSA of cities dropping below a population of 5,000, which is the eligibility threshold for receiving MSA for street maintenance. Under previous law, if a city that formerly had a population of 5,000 or more fell below a 5,000 population at the 2010 decennial census, it would have been ineligible for MSA beginning in fiscal 2012. The first change enacted allows previously eligible cities falling below 5,000 population at a decennial census to continue to be considered to have a population of 5,000 for purposes of calculating MSA, thereby remaining eligible, until the end of the fourth year of the decade. The second change enacted states that for purposes of calculating MSA, which is based 50 percent on population, a city is deemed to have a population equal to the greater of 5,000 or as otherwise determined by statute. The final change requires that, for 2013 MSA only, the aid be allocated in a manner that backfills the MSA cities lost in 2012 due to population drops.

Contractor Bond Threshold – The threshold at which a municipality is required to obtain contractor performance and payment bonds for public construction contracts was increased from $75,000 to match the current competitive bid law threshold of $100,000.

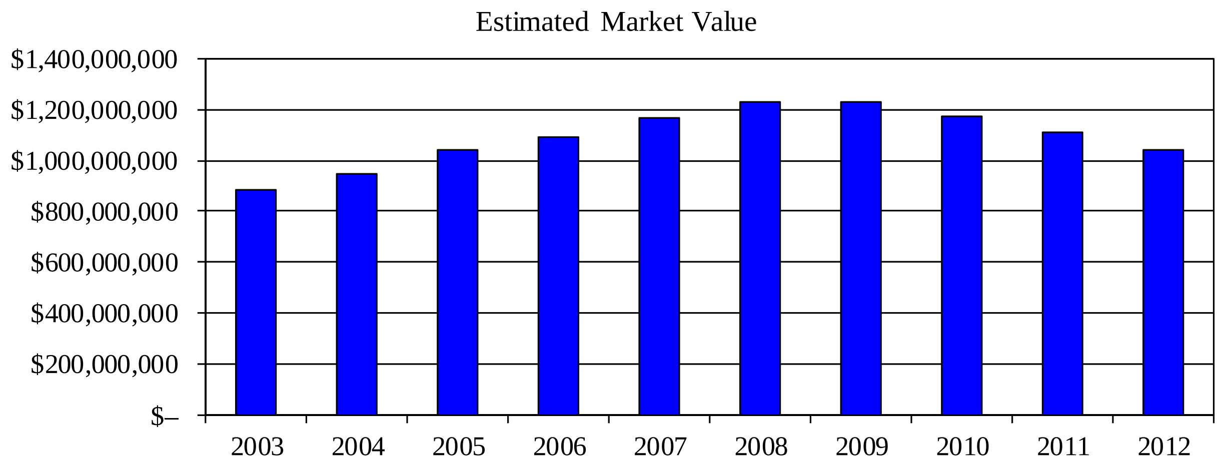
Municipal Detachment of Parcels – A number of corrections and clarifications were made related to petitions for the detachment of parcels from a municipality. The changes affect petition requirements, the hearing process, and the sharing of associated hearing and mediation costs with the landowners.

Tort Liability Limits for Cities Contracting With Certain Nonprofits – The liability limit on claims against cities involving nonprofit organizations that are engaged in or administer outdoor recreational activities that are funded or authorized by a municipality were lowered from $1.5 million to $1.0 million.

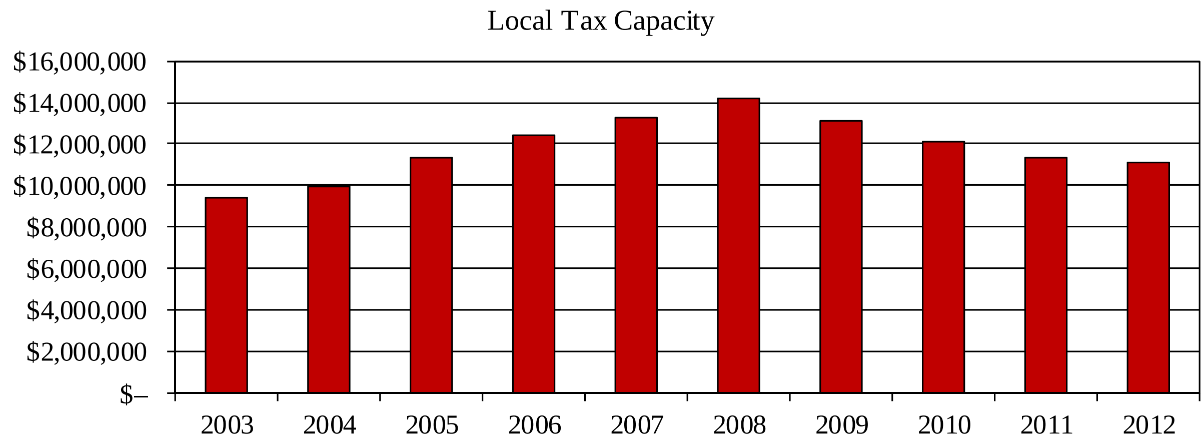
PROPERTY TAXES

Minnesota cities rely heavily on local property tax levies to support their governmental fund activities. In recent years this dependence has been heightened due to reductions in state aids and fees from new development due to the struggling economy. As a result, many cities have repeatedly been faced with the difficult choice of either reducing services or increasing taxes on their already overburdened constituents.

Property values within Minnesota cities experienced average decreases of 5.7 percent and 8.8 percent for taxes payable in 2011 and 2012, respectively, as market values have continued to slide despite recent signs of improvement in other areas of the economy. In comparison, the City's taxable market value decreased 5.3 percent and 5.9 percent for 2011 and 2012, respectively. The market value for taxes payable in 2012 is based on estimated values as of January 1, 2011. The following graph shows the City's changes in taxable market value over the past 10 years:



Tax capacity is considered the actual base available for taxation. It is calculated by applying the state's property classification system to each property's market value. Each property classification, such as commercial or residential, has a different calculation and uses different rates. Consequently, a city's total tax capacity will change at a different rate than its total market value, as tax capacity is affected by the proportion of the City's tax base that is in each property classification from year-to-year, as well as legislative changes to tax rates. The City's tax capacity decreased 6.6 percent and 1.7 percent for taxes payable in 2011 and 2012, respectively. The following graph shows the City's change in tax capacities over the past 10 years:



The following table presents the average tax rates applied to city residents for each of the last two levy years, along with comparative state-wide and metro area rates. The general increase in rates reflects both the increased reliance of local governments on property taxes and the recent decline in tax capacities.

Rates expressed as a percentage of net tax capacity

	All Cities State-Wide		Seven-County Metro Area		**City of Arden Hills**	
	2011	2012	2011	2012	**2011**	**2012**
Average tax rate						
City	42.5	46.3	40.0	43.4	**24.2**	**25.5**
County	43.7	46.8	42.1	45.0	**54.7**	**61.3**
School	25.2	27.3	26.8	28.5	**25.1**	**28.6**
Special taxing	6.4	6.8	8.1	8.7	**8.4**	**10.0**
Total	117.8	127.2	117.0	125.6	**112.4**	**125.4**

There are a number of reasons contributing to the change in the average total tax rate. The City's portion of the tax capacity rates for the City's residents has historically been well below the average for Minnesota cities state-wide and for cities in the seven-county metro area because of the City's high property values and strong commercial tax base. The City does not have any outstanding debt levy requirement, which also contributes to the lower than average city tax rate.

GOVERNMENTAL FUNDS OVERVIEW

This section of the report provides you with an overview of the financial trends and activities of the City's governmental funds, which includes the General Fund, special revenue, debt service, and capital project funds. These funds are used to account for the basic services the City provides to all of its citizens, which are financed primarily with property taxes. The governmental fund information in the City's financial statements focuses on budgetary compliance, and the sufficiency of each governmental fund's current assets to finance its current liabilities.

GOVERNMENTAL FUND BALANCES

The following table summarizes the changes in the fund balances of the City's governmental funds during the year ended December 31, 2012, presented both by fund balance classification and by fund:

Governmental Fund Change in Fund Balance

	Fund Balance as of December 31, 2012	Fund Balance as of December 31, 2011	Increase (Decrease)
Fund balances of governmental funds			
Total by classification			
Nonspendable	$ 22,954	$ 29,063	$ (6,109)
Restricted	1,799,380	1,696,379	103,001
Committed	452,496	264,016	188,480
Assigned	6,989,249	7,100,359	(111,110)
Unassigned	1,899,120	1,472,859	426,261
Total governmental funds	$ 11,163,199	$ 10,562,676	$ 600,523
Total by fund			
General	$ 2,350,919	$ 2,151,335	$ 199,584
EDA Operating	297,475	109,642	187,833
Tax Increment bonds	2,167	2,167	–
Equipment, Building, and Replacement	(232,240)	(353,928)	121,688
Permanent Improvement Revolving	6,502,758	6,507,850	(5,092)
Other governmental funds	2,242,120	2,145,610	96,510
Total governmental funds	$ 11,163,199	$ 10,562,676	$ 600,523

In total, the fund balances of the City's governmental funds increased by $600,523 during the year ended December 31, 2012. The majority of the increase was in unassigned fund balance, which increased $426,261 due to the positive operating results of the General Fund and Equipment, Building, and Replacement Fund. Committed fund balance increased $188,480 for economic development activities. Restricted fund balance increased $103,001 for tax increment purposes. These increases in fund balance were offset by the decrease in assigned fund balance for capital equipment and buildings.

GOVERNMENTAL FUND REVENUES

The following table presents the per capita revenue of the City's governmental funds for the past three years, along with state-wide averages.

We have included the most recent comparative state-wide averages available from the Office of the State Auditor to provide a benchmark for interpreting your city's data. The amounts received from the typical major sources of governmental fund revenue will naturally vary between cities based on factors such as the City's stage of development, location, size and density of its population, property values, services it provides, and other attributes. It will also differ from year-to-year due to the effect of inflation and changes in the City's operation. Also, certain data on these tables may be classified differently than how they appear on the City's financial statements in order to be more comparable to the state-wide information, particularly in separating capital expenditures from current expenditures.

We have designed this section of our management report using per capita data in order to better identify unique or unusual trends and activities of your city. We intend for this type of comparative and trend information to complement, rather than duplicate, information in the Management's Discussion and Analysis. An inherent difficulty in presenting per capita information is the accuracy of the population count, which for most years is based on estimates.

Governmental Funds Revenue per Capita
With State-Wide Averages by Population Class

	State-Wide			**City of Arden Hills**		
Year	December 31, 2011			**2010**	**2011**	**2012**
Population	2,500–10,000	10,000–20,000	20,000–100,000	**9,552**	**9,552**	**9,642**
Property taxes	$ 390	$ 363	$ 406	**$ 300**	**$ 305**	**$ 320**
Tax increments	40	48	51	**59**	**36**	**45**
Franchise and other taxes	27	36	30	**9**	**9**	**10**
Special assessments	70	56	56	**41**	**59**	**26**
Licenses and permits	23	21	31	**27**	**45**	**43**
Intergovernmental revenues	283	263	152	**92**	**26**	**15**
Charges for services	95	79	78	**34**	**44**	**47**
Other	65	75	65	**46**	**80**	**45**
Total revenue	$ 993	$ 941	$ 869	**$ 608**	**$ 604**	**$ 551**

The City's governmental funds have generated significantly less revenue per capita in total than other Minnesota cities in its population class. A city's stage of development, along with the way a city finances various capital projects, will impact the mix of revenue sources it receives.

The City generated $5,312,405 of total revenue in its governmental funds in 2012, a decrease of $453,369 (7.9 percent) from the prior year. The City's per capita governmental funds revenues for 2012 were $551, a decrease of $53 (8.8 percent) per capita from the prior year. Special assessments decreased $33 per capita as a result of the City having less street projects in the current year that were certified to the county. Other revenue decreased $35 per capita due to decreased conduit debt application fees and park dedication fees received.

GOVERNMENTAL FUND EXPENDITURES

The expenditures of governmental funds will also vary from state-wide averages and from year-to-year, based on the City's circumstances. Expenditures are classified into three types as follows:

- **Current** – These are typically the general operating type expenditures occurring on an annual basis, and are primarily funded by general sources such as taxes and intergovernmental revenues.

- **Capital Outlay and Construction** – These expenditures do not occur on a consistent basis, more typically fluctuating significantly from year-to-year. Many of these expenditures are project-oriented, and are often funded by specific sources that have benefited from the expenditure, such as special assessment improvement projects.

- **Debt Service** – Although the expenditures for debt service may be relatively consistent over the term of the respective debt, the funding source is the important factor. Some debt may be repaid through specific sources such as special assessments or redevelopment funding, while other debt may be repaid with general property taxes.

The City's expenditures per capita of its governmental funds for the past three years, together with state-wide averages, are presented in the following table:

Governmental Funds Expenditures per Capita
With State-Wide Averages by Population Class

	State-Wide			**City of Arden Hills**		
Year	December 31, 2011			**2010**	**2011**	**2012**
Population	2,500–10,000	10,000–20,000	20,000–100,000	**9,552**	**9,552**	**9,642**
Current						
General government	$ 126	$ 99	$ 82	**$ 118**	**$ 111**	**$ 109**
Public safety	231	225	238	**163**	**172**	**179**
Public works	114	108	89	**34**	**29**	**39**
Parks and recreation	79	96	87	**63**	**69**	**70**
All other	74	81	82	**–**	**1**	**6**
	$ 624	$ 609	$ 578	**$ 378**	**$ 382**	**$ 403**
Capital outlay and construction	$ 258	$ 272	$ 233	**$ 223**	**$ 199**	**$ 70**
Debt service						
Principal	$ 186	$ 148	$ 109	**$ 25**	**$ 26**	**$ 26**
Interest and fiscal	60	48	41	**5**	**4**	**3**
	$ 246	$ 196	$ 150	**$ 30**	**$ 30**	**$ 29**

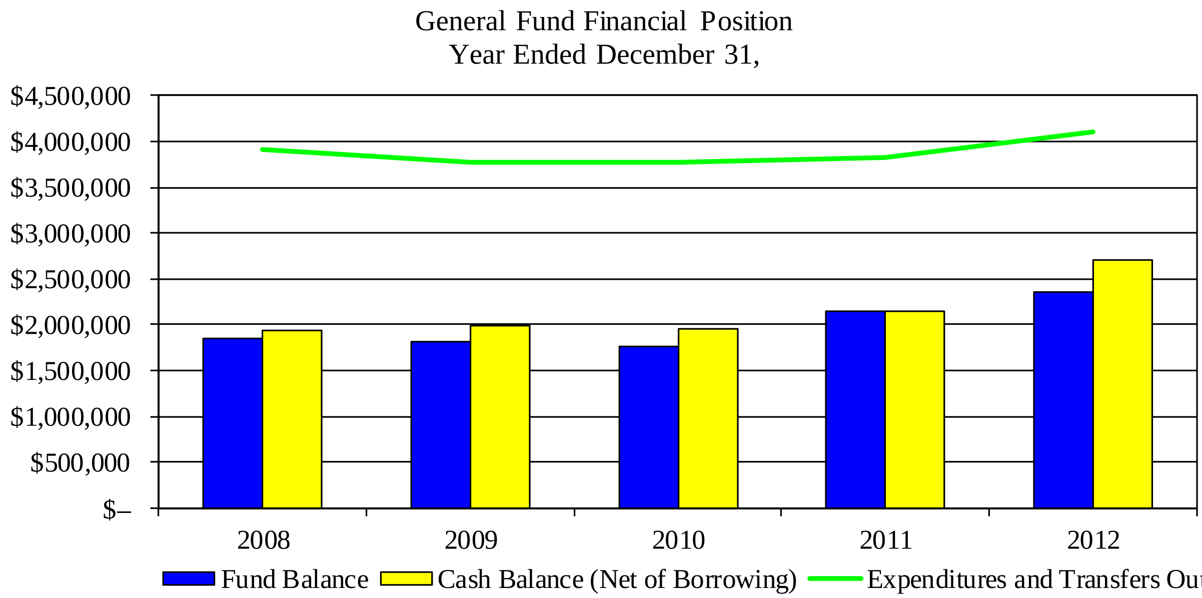
As the above table reflects, the City's expenditures per capita have also been below the state-wide average. A significant reason for this difference is in capital outlay and debt service, which is reasonable for a city that is not in the middle of a major development or redevelopment period.

Total expenditures in the City's governmental funds for 2012 were $4,854,882, a decrease of $976,936 (16.8 percent). The City's per capita governmental funds current expenditures for 2012 were $403, an increase of $21 (5.5 percent) per capita from the prior year. Increases in public safety for police fire contract service fees and in public works for new software and technology implemented in the current year contributed to the overall increase in current expenditures. Capital outlay and construction experienced a decrease from the prior year due to no major street projects or capital equipment purchases in the current year. Debt service expenditures were similar to the prior year as planned with scheduled debt payments.

GENERAL FUND

The City's General Fund accounts for the financial activity of the basic services provided to the community. The primary services included within this fund are the administration of the municipal operation, police and fire protection, building inspection, street maintenance, and parks and recreation.

The graph below illustrates the change in the General Fund financial position over the last five years. We have also included a line representing annual expenditures and transfers out to reflect the change in the size of the General Fund operation over the same period.

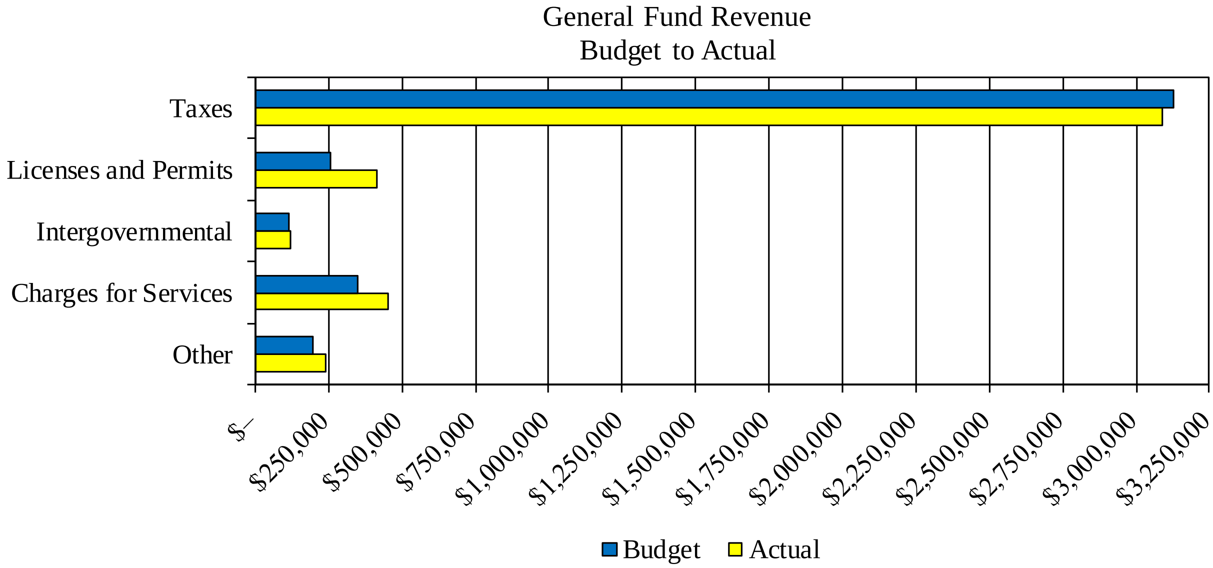


The City's General Fund cash and investments balance at December 31, 2012 was $2,707,784 (net of borrowing), an increase of $567,297 from the previous year. Total fund balance at December 31, 2012 was $2,350,919, an increase of $199,584 from the prior year. This fund balance level represents approximately 63 percent of the City's annual General Fund expenditures, based on 2012 expenditure levels, which compares to a prior year fund balance level of 60 percent. The overall impact of operations on fund balance was $324,539 better than anticipated in the final budget.

As the graph illustrates, the City has generally been able to maintain stable cash and fund balance levels as the volume of financial activity has fluctuated. This is an important factor because a government, like any organization, requires a certain amount of equity to operate. A healthy financial position allows the City to avoid volatility in tax rates; helps minimize the impact of state funding changes; allows for the adequate and consistent funding of services, repairs, and unexpected costs; and is a factor in determining the City's bond rating and resulting interest costs. Maintaining an adequate fund balance has become increasingly important given the fluctuations in state funding for cities in recent years.

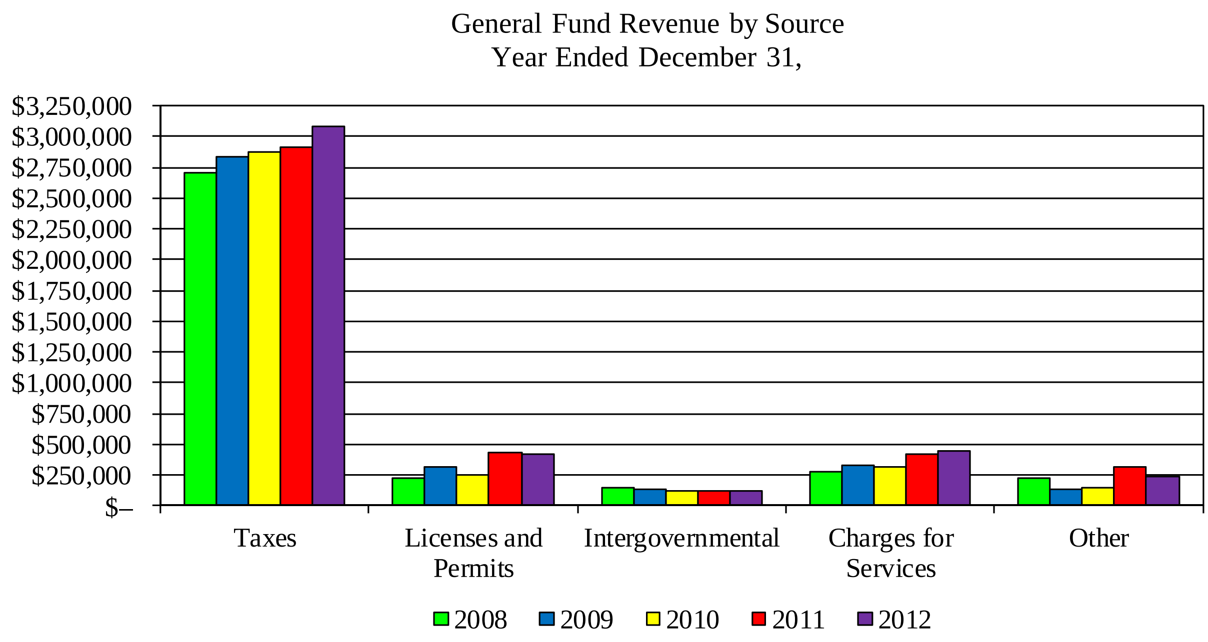
A trend that is typical to Minnesota local governments, especially the General Fund of cities, is the unusual cash flow experienced throughout the year. The City's General Fund cash disbursements are made fairly evenly during the year other than the impact of seasonal services such as snowplowing, street maintenance, and park activities. Cash receipts of the General Fund are quite a different story. Property taxes comprise approximately 72 percent of the fund's total annual revenue. Approximately half of these revenues are received by the City in July and the rest in December. Consequently, the City needs to have adequate cash reserves to finance its everyday operations between these payments.

The following graph reflects the City's General Fund revenues, budget and actual, for 2012:



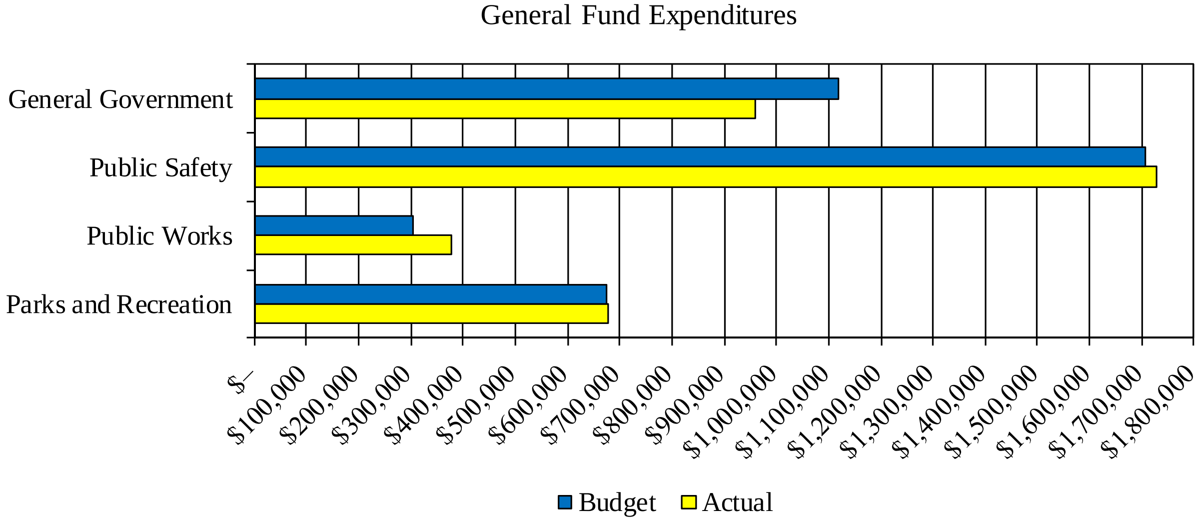
Total General Fund revenues for 2012 were $4,309,627, which was $265,501 (6.6 percent) over the final budget. The largest variance occurred in licenses and permits, which were $158,220 above anticipated levels. The impact of building permit fees related to new construction contributed to this variance. Charges for services were also over budget by $100,698 due to plan check fees related to the new construction.

The following graph presents the City's General Fund revenues by source for the last five years:



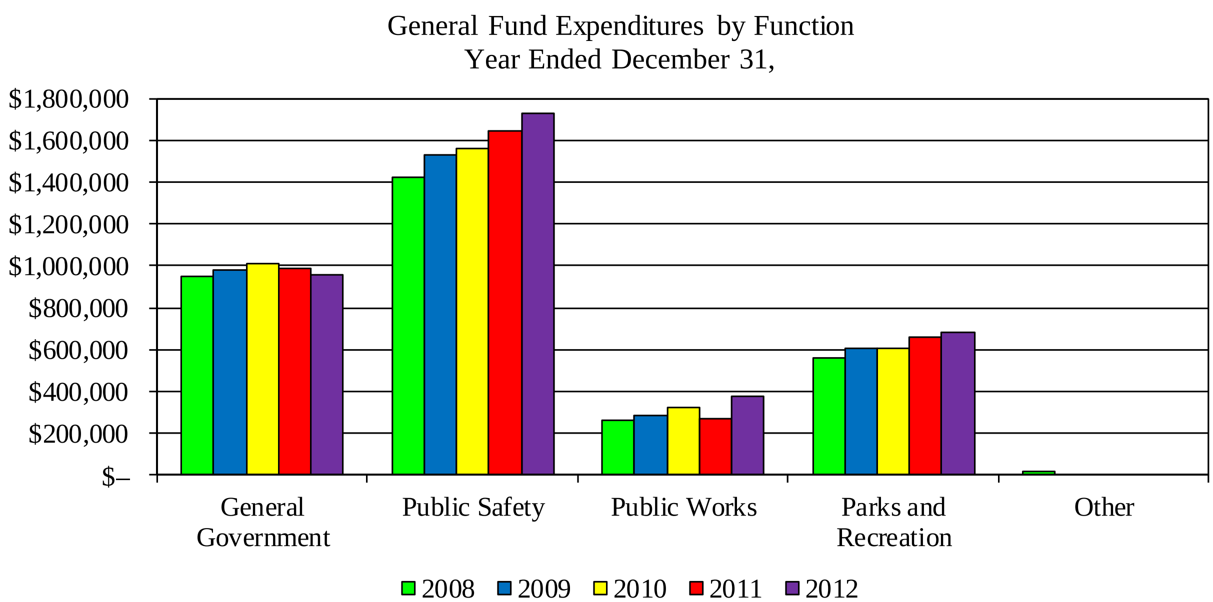
Total General Fund revenue for 2012 was $104,330 (2.5 percent) higher than last year. Property tax revenue increased $173,912 due to approved increases in the annual levy, improved collection rates on delinquencies, and due to the elimination of the MVHC aid subtraction. This increase was offset by the $78,162 decrease in other revenues. Other revenues decreased as a result of decreased park dedication fees and decreased fees received on conduit debt issued.

The following graph reflects the City's General Fund expenditures, budget and actual, for 2012:



Total General Fund expenditures for 2012 were $3,745,088, which was $59,038 (1.6 percent) under the final budget. As presented in the budgetary comparison schedule (within the City's CAFR) expenditure variances were both over and under within various functions and departments, while remaining within total appropriations approved by the City Council. The general government function was $158,290 under budget, mainly in the planning and zoning ($77,570) and administration ($40,130) departments. This was partially offset by the public safety, public works, and parks and recreation functions being over budget $21,340, $72,545, and $5,367, respectively.

The following graph presents the City's General Fund expenditures by function for the last five years.



Overall, General Fund expenditures increased $180,240 (5.1 percent) from the prior year. Public safety increased $87,868 due to increased contract fees for police and fire services. Public works increased $103,936 due to increased engineering costs as a result of the City implementing new technologies and software to help increase efficiencies.

ENTERPRISE FUNDS OVERVIEW

The City maintains a number of enterprise funds to account for services the City provides that are financed primarily through fees charged to those utilizing the service. This section of the report provides you with an overview of the financial trends and activities of the City's enterprise funds, which include the Water, Sewer, Surface Water Management, and Recycling Funds.

The utility funds comprise a considerable portion of the City's activities. These funds significantly help to defray overhead and administrative costs and provide additional support to general government operations by way of annual transfers. We understand that the City is proactive in reviewing these activities on an ongoing basis and we want to reiterate the importance of continually monitoring these operations. Over the years, we have emphasized to our city clients the importance of these utility operations being self-sustaining, preventing additional burdens on general government funds. This would include the accumulation of net assets for future capital improvements and to provide a cushion in the event of a negative trend in operations.

ENTERPRISE FUNDS FINANCIAL POSITION

The following table summarizes the changes in the financial position of the City's enterprise funds during the year ended December 31, 2012, presented both by classification and by fund:

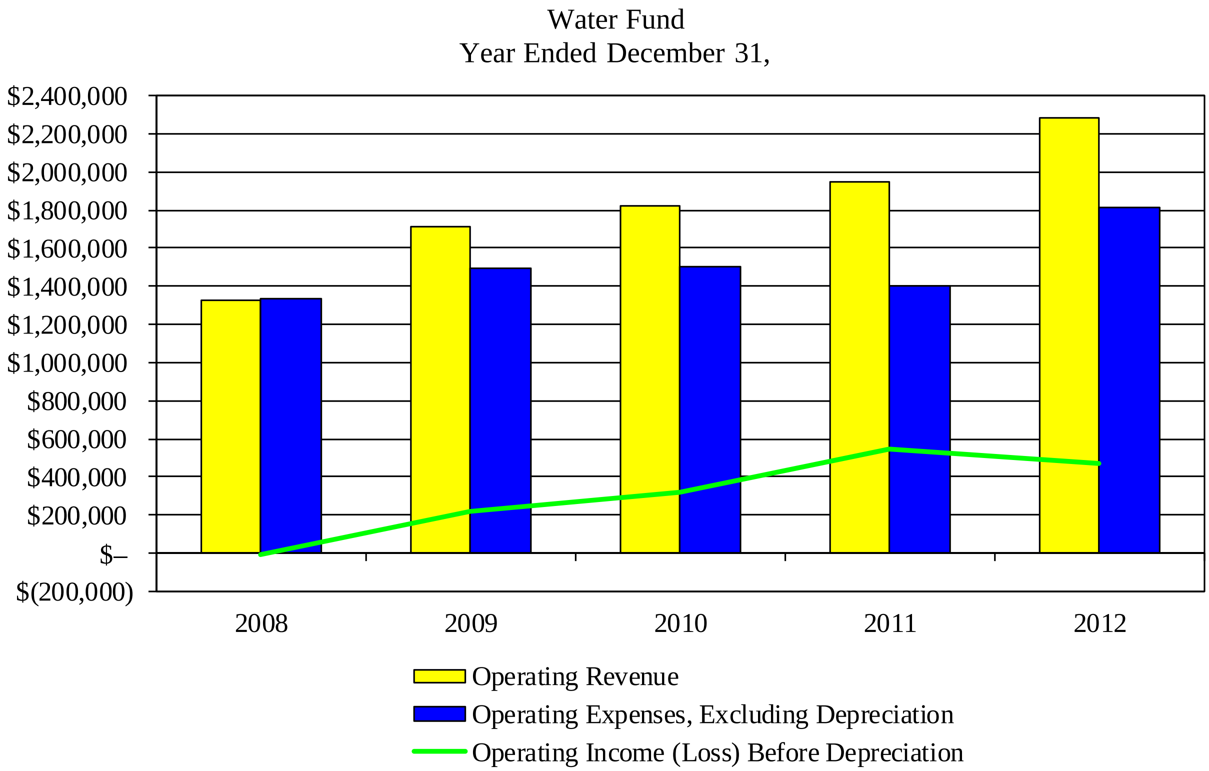
Enterprise Funds Change in Financial Position

	Net Position as of December 31,		Increase
	2012	2011	(Decrease)
Net position of enterprise funds			
Total by classification			
Net investment in capital assets	$ 12,360,674	$ 10,961,855	$ 1,398,819
Unrestricted	2,403,645	3,248,534	(844,889)
Total enterprise funds	$ 14,764,319	$ 14,210,389	$ 553,930
Total by fund			
Water	$ 6,705,284	$ 6,417,260	$ 288,024
Sewer	4,884,862	4,773,759	111,103
Surface Water Management	3,103,395	2,949,669	153,726
Nonmajor Recycling	70,778	69,701	1,077
Total enterprise funds	$ 14,764,319	$ 14,210,389	$ 553,930

In total, the net position of the City's enterprise funds increased by $553,930 during the year ended December 31, 2012. As noted in the table above, all of the enterprise funds experienced an increase in net position. The shift between net investment in capital assets and unrestricted net position is due to the City's increased investment in utility infrastructure.

WATER FUND

The following graph presents five years of operating results for the Water Fund:



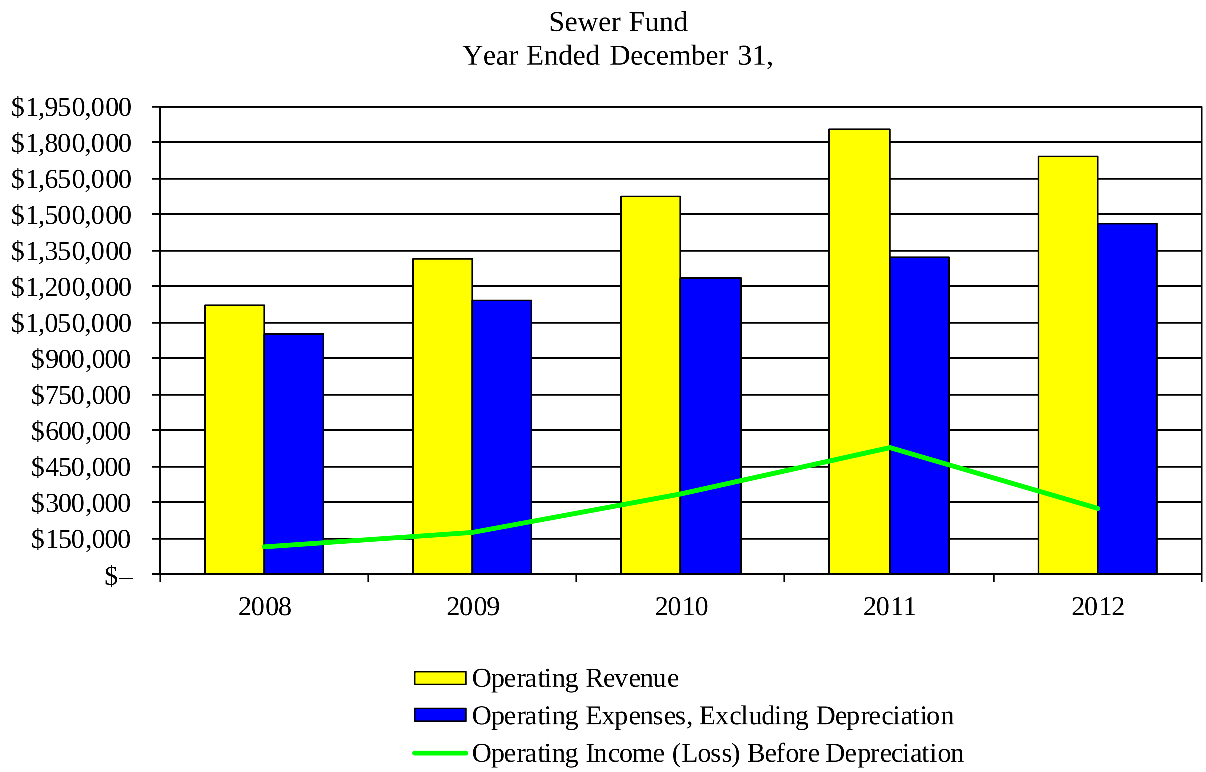
The Water Fund ended 2012 with a net position of $6,705,284, an increase of $288,024 from the prior year. Of this, $5,229,502 represents the net investment in capital assets, leaving $1,475,782 of unrestricted net position.

Water Fund operating revenues were $2,285,161 for 2012, an increase of $334,229. This increase was primarily due to increased utility rates and increased consumption as a result of the dry summer, and increased irrigation billings. Operating expenses (excluding depreciation of $171,299) were $1,811,901, which represents an increase of $410,400 (29.3 percent). This increase was largely due to an increase in water purchased from the City of Roseville and increased services and charges due to increased engineering costs.

Consumption will fluctuate from year-to-year based on many factors, including weather patterns and number of utility customers.

SEWER FUND

The following graph presents five years of operating results for the Sewer Fund:

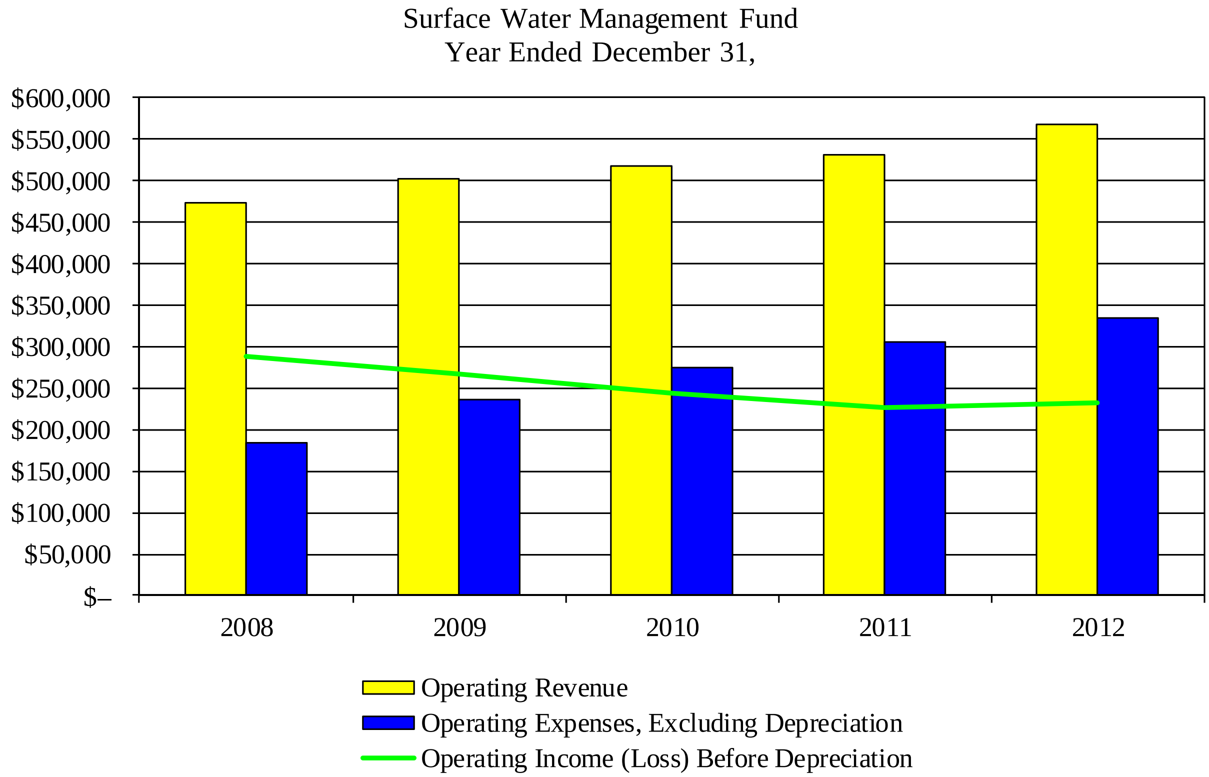


The Sewer Fund ended 2012 with a net position of $4,884,862, an increase of $111,103 from the prior year. Of this, $4,678,297 represents the net investment in capital assets, leaving $206,565 of unrestricted net position.

Sewer Fund operating revenues for 2012 were $1,739,123, a decrease of $113,241 from last year. This decrease was a result of sewer access charges and sewer availability charges being down from the prior year. Operating expenses for 2012 (excluding depreciation of $131,202) were $1,464,177, up $140,650 from the prior year, with the largest increase in other services and charges due to increased engineering costs.

SURFACE WATER MANAGEMENT FUND

The following graph presents five years of operating results for the Surface Water Management Fund:

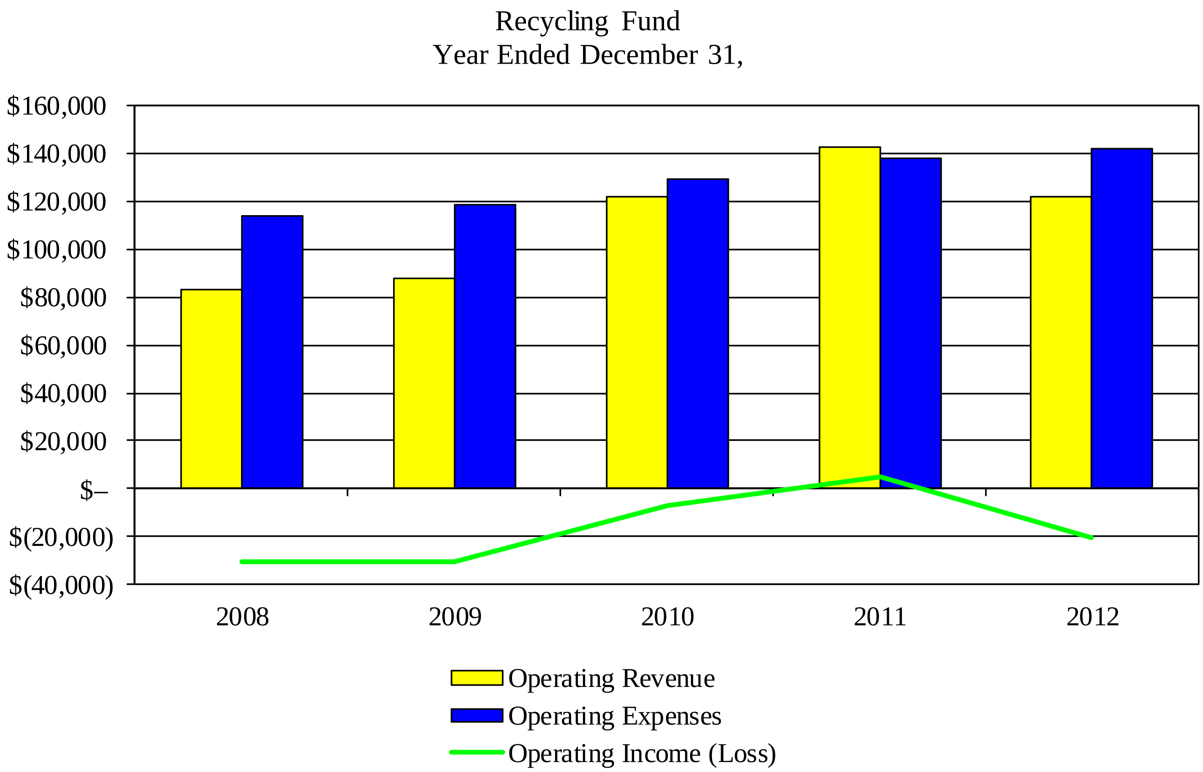


The Surface Water Management Fund ended 2012 with a net position of $3,103,395, an increase of $153,726 from the prior year. Of this, $2,452,875 represents the net investment in capital assets, leaving $650,520 of unrestricted net position.

Surface Water Management Fund operating revenues for 2012 were $567,361, an increase of $35,516 from last year. This increase is consistent with the utility rate increase approved for 2012. Operating expenses for 2012 (excluding depreciation of $53,148) were $335,258, or $29,322 more than the prior year due primarily to an increase in other services charged to this utility operation.

RECYCLING FUND

The following graph presents five years of operating results for the Recycling Fund:



The Recycling Fund ended 2012 with an unrestricted net position of $70,778, an increase of $1,077 from the prior year.

Recycling Fund operating revenues for 2012 were $121,688, a decrease of $21,170 from last year, due to the change in recyclable materials markets reducing the City's share in this source. Operating expenses for 2012 were $142,114, an increase of $4,492 from the prior year. The Recycling Fund also received $19,802 of intergovernmental revenues which are not reflected in the graph above that are available for the operation of the City's recycling program.

GOVERNMENT-WIDE FINANCIAL STATEMENTS

In addition to fund-based information, the current reporting model for governmental entities also requires the inclusion of two government-wide financial statements designed to present a clear picture of the City as a single, unified entity. These government-wide statements provide information on the total cost of delivering services, including capital assets and long-term liabilities.

STATEMENT OF NET POSITION

The Statement of Net Position essentially tells you what your city owns and owes at a given point in time, the last day of the fiscal year. Theoretically, net position represents the resources the City has leftover to use for providing services after its debts are settled. However, those resources are not always in spendable form, or there may be restrictions on how some of those resources can be used. Therefore, net position is divided into three components: net investment in capital assets, restricted, and unrestricted.

The following table presents the components of the City's net position as of December 31, 2012 and 2011 for governmental activities and business-type activities (utility fund operations):

	As of December 31,		Increase
	2012	2011	(Decrease)
Net position			
Governmental activities			
Net investment in capital assets	$ 17,167,531	$ 17,498,478	$ (330,947)
Restricted	1,788,007	1,694,212	93,795
Unrestricted	9,738,832	9,133,279	605,553
Total governmental activities	28,694,370	28,325,969	368,401
Business-type activities			
Net investment in capital assets	12,360,674	10,961,855	1,398,819
Unrestricted	2,403,645	3,248,534	(844,889)
Total business-type activities	14,764,319	14,210,389	553,930
Total net position	$ 43,458,689	$ 42,536,358	$ 922,331

The City's total net position at December 31, 2012 was $922,331 higher than the total net position reported at the previous year-end. Of the increase, $368,401 came from governmental activities and $553,930 from business-type activities. At the end of the current fiscal year, the City is able to present positive balances in all three categories of net position, both for the City as a whole as well as for its separate governmental and business-type activities. The same situation held true for the prior fiscal year.

STATEMENT OF ACTIVITIES

The Statement of Activities tracks the City's yearly revenues and expenses, as well as any other transactions that increase or reduce total net positions. These amounts represent the full cost of providing services. The Statement of Activities provides a more comprehensive measure than just the amount of cash that changed hands, as reflected in the fund-based financial statements. This statement includes the cost of supplies used, depreciation of long-lived capital assets, and other accrual-based expenses.

The following table presents the change in the net position of the City for the years ended December 31, 2012 and 2011:

	2012			2011
	Expenses	Program Revenues	Net Change	Net Change
Net (expense) revenue				
Governmental activities				
General government	$ 1,186,404	$ 504,625	$ (681,779)	$ (601,412)
Public safety	1,900,443	490,495	(1,409,948)	(1,239,419)
Public works	894,954	141,177	(753,777)	120,998
Parks and recreation	838,138	157,451	(680,687)	(437,032)
Economic development	61,770	5,050	(56,720)	(6,785)
Interest on long-term debt	31,287	–	(31,287)	(39,146)
Business-type activities				
Water	1,983,200	2,285,161	301,961	377,263
Sewer	1,595,379	1,764,629	169,250	528,193
Surface water management	388,406	567,361	178,955	188,812
Recycling	142,114	141,490	(624)	26,082
Total net (expense) revenue	$ 9,022,095	$ 6,057,439	(2,964,656)	(1,082,446)
General revenues				
Property taxes			3,095,488	2,920,078
Tax increment collections			431,060	342,109
Franchise taxes			94,532	90,123
Unrestricted investment earnings			265,907	389,025
Gain on sale of capital assets			–	46,712
Total general revenues			3,886,987	3,788,047
Change in net position			$ 922,331	$ 2,705,601

One of the goals of this statement is to provide a side-by-side comparison to illustrate the difference in the way the City's governmental and business-type operations are financed. The City's governmental operations tend to rely more heavily on general revenues, such as property taxes and unrestricted grants. In contrast, the City's business-type activities tend to rely more heavily on program revenues like charges for services (sales) and program specific grants to cover expenses. This is critical given the current external downward pressures on general revenue sources such as taxes and state aids.

ACCOUNTING AND AUDITING UPDATES

GASB STATEMENT NO. 61 – THE FINANCIAL REPORTING ENTITY: OMNIBUS

This statement amends the current guidance in GASB Statement No. 14, *The Financial Reporting Entity*, for identifying and presenting component units. Potential component units that meet the fiscal dependency criterion for inclusion in the financial reporting entity under existing guidance will only be included if there is also "financial interdependency" (an ongoing relationship of potential financial benefit or burden) with the primary government. This statement also clarifies the types of relationships that are considered to meet the "misleading to exclude" criterion for inclusion as a component unit; changes the criteria for blending component units; gives direction for the determination and disclosure of major component units; and adds a requirement to report an explicit, measurable equity interest in a discretely presented component unit in a statement of position prepared using the economic resources measurement focus. The requirements of this statement must be implemented for periods beginning after June 15, 2012, with earlier implementation encouraged.

GASB STATEMENT NO. 65 – ITEMS PREVIOUSLY REPORTED AS ASSETS AND LIABILITIES

This statement establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items previously reported as assets and liabilities; and recognizes, as outflows or inflows of resources, certain items previously reported as assets and liabilities. This statement also provides financial reporting guidance related to the impact of the financial statement elements deferred outflows of resources and deferred inflows of resources, such as changes in the determination of the major fund calculations and limiting the use of the term *deferred* in financial statement presentations. The provisions of this statement are effective for financial statements for periods beginning after December 15, 2012. Earlier application is encouraged.

GASB STATEMENT NO. 67 – FINANCIAL REPORTING FOR PENSION PLANS – AN AMENDMENT OF GASB STATEMENT NOS. 25 AND 50

The primary objective of this statement is to improve financial reporting by state and local government pension plans. GASB Statement No. 67 replaces the requirements of GASB Statement Nos. 25 and 50 for pension plans that are administered through trusts or equivalent arrangements that meet the following criteria: contributions from employers and nonemployer contributing entities to the pension plan and earnings on those contributions are irrevocable; pension plan assets are dedicated to providing pensions to plan members in accordance with the benefit terms; and pension plan assets are legally protected from the creditors of employers, nonemployer contributing entities, and the pension plan administrator. If the plan is a defined benefit pension plan, plan assets also are legally protected from creditors of the plan members. The requirements of GASB Statement Nos. 25 and 50 remain applicable to pension plans that are not administered through trusts covered by the scope of this statement and to defined contribution plans that provide post-employment benefits other than pensions. The statement makes a number of changes in the financial statement presentation, measurement, and required disclosures relating to the reporting of these types of pension plans. This statement is effective for financial statements for fiscal years beginning after June 15, 2013. Earlier application is encouraged.

GASB STATEMENT NO. 68 – ACCOUNTING AND FINANCIAL REPORTING FOR PENSIONS – AN AMENDMENT OF GASB STATEMENT NOS. 27 AND 50

The primary objective of this statement is to improve accounting and financial reporting by state and local governments for pensions. This statement replaces the requirements of GASB Statement Nos. 27 and 50, as they relate to pensions that are provided through pension plans administered as trusts or equivalent arrangements that meet certain criteria (as described earlier for GASB Statement No. 67). The requirements of GASB Statement Nos. 27 and 50 remain applicable for pensions that are not covered by the scope of this statement.

This statement establishes standards for measuring and recognizing liabilities, deferred outflows of resources, deferred inflows of resources, and expense/expenditures. In addition, this statement details the recognition and disclosure requirements for employers with liabilities (payables) to a defined benefit pension plan and for employers whose employees are provided with defined contribution pensions. This statement also addresses circumstances in which a nonemployer entity has a legal requirement to make contributions directly to a pension plan. This statement is effective for financial statements for fiscal years beginning after June 15, 2014. Earlier application is encouraged.

Included in this statement are major changes in how employers that participate in cost-sharing pension plans, such as TRA and PERA, account for pension benefit expenses and liabilities. In financial statements prepared using the economic resources measurement focus and accrual basis of accounting (government-wide and proprietary funds), a cost-sharing employer that does not have a special funding situation is required to recognize a liability for its proportionate share of the net pension liability of all employers with benefits provided through the pension plan. A cost-sharing employer is required to recognize pension expense and report deferred outflows of resources and deferred inflows of resources related to pensions for its proportionate share of collective pension expense and collective deferred outflows of resources and deferred inflows of resources related to pensions. In addition, the effects of (1) a change in the employer's proportion of the collective net pension liability and (2) differences during the measurement period between the employer's contributions and its proportionate share of the total of contributions from employers included in the collective net pension liability are required to be determined. These effects are required to be recognized in the employer's pension expense in a systematic and rational manner over a closed period equal to the average of the expected remaining service lives of all active and inactive employees that are provided with pensions through the pension plan.

GASB STATEMENT NO. 69 – GOVERNMENT COMBINATIONS AND DISPOSALS OF GOVERNMENT OPERATIONS

This statement provides accounting and financial reporting guidance, including disclosure requirements, for government combinations and disposals of government operations. Government combinations include mergers, acquisitions, and transfers of operations. Included within the scope of this statement are combinations of governmental entities or combinations of governmental entities, with nongovernmental entities (such as a nonprofit entity) as long as the new or continuing organization is a government. This statement does not apply to combinations in which a government acquires an organization that continues to exist as a separate entity, or acquires an equity interest in an organization that remains legally separate from the acquiring government. A disposal of operations occurs when a government either transfers or sells specific operations. The provisions of this statement are effective for financial statements for periods beginning after December 15, 2013. Earlier application is encouraged.

PROPOSED CHANGES TO REQUIREMENTS FOR FEDERAL GRANTS

The U.S. Office of Management and Budget (OMB) has issued for comment *Proposed OMB Uniform Guidance: Cost Principles, Audit, and Administrative Requirements for Federal Awards*, which proposes broad revisions to OMB Circular A-133 and other key grant reforms. The proposed guidance includes a number of significant changes to the federal Single Audit process, including; an increase in dollar threshold for requiring a Single Audit, changes to the process for determining major programs, a reduction in the percentage of expenditures required to be covered by a Single Audit, revised criteria for determining low-risk auditees, a reduction in the types of compliance requirements to be tested, and an increase in the threshold for reporting questioned costs. The proposed guidance would also consolidate OMB circulars and cost principles; and change certain federal requirements related to indirect costs, time and effort reporting, and grant administration.